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COORDINATED ISSUE
RETAIL INDUSTRY
HEATING, VENTILATING AND AIR CONDITIONING (HVAC) SYSTEMS
ACRS & ITC

Facts

A company that is in the retail grocery business, installed central heating, ventilating and air conditioning systems (HVAC) in its grocery stores. It claimed an investment credit on the purchase of the systems and used the three and five year recovery periods that are provided by ACRS for Section 1245 property. The taxpayer company asserted that the sole justification for the purchase of the systems was to meet the temperature and humidity requirements of its open-front display cases containing frozen foods.

Question

Do HVAC units installed in retail grocery stores qualify for the investment tax credit and for the three or five year recovery periods provided by ACRS?

Law

(Prior to enactment of the 1986 Tax Reform Act which extended the lives of the ACRS property and eliminated the investment tax credit.)

Proposed Regulation Section 1.168-1 states that "Section 168 of the Internal Revenue Code of 1954 provides a system for determining cost recovery deductions for recovery property, the Accelerated Cost Recovery System (ACRS)." The definition of recovery property and the classification of property into recovery categories of 3, 5, 10 and 15 years are provided in Regulation Section 1.168-3. Regulation Section 1.168-3 defines property in the 3-year and 5-year recovery categories as Section 1245 property.

Section 38 of the Internal Revenue Code allows a credit against Federal Income Tax for qualified investments in "Section 38 property." The term "Section 38 property" is defined by Section 48(a)(1), which provides in part:

> (A) Section 38 Property -
>
> > (1) In general. Except as provided in this subsection, the term "Section 38 property" means -

(a) tangible personal property (other than an air conditioning or heating unit), or

(b) other tangible property (not including a building and its structural components) but only if such property -

(i) is used as an integral part of manufacturing, production or extraction, or of furnishing transportation, communications, electrical energy, gas, water or sewage disposal services...

Pursuant to Section 38(b), the term "structural component of a building" is defined by Treas. Reg. Section 1.48-1(e)(2) as follows:

> The term "structural component" includes such parts of a building as walls, partitions, floors and ceilings, as well as any permanent coverings therefore, such as panelling or tiling; windows and doors, all components (whether in, on or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts;... However, the term "structural component" does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential to the operations of other machinery or the processing of materials or foodstuffs. Machinery may meet the "sole justification" test provided by the preceding sentence even though it incidentally provides for the comfort of employees or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential. (Emphasis added.)

In Dixie Manor, Inc. vs. U.S. (W.D. Ky 1979), 79-2 USTC p. 9469, 44 AFTR F.2d 79-5442 the court held that air conditioners in a shopping center were structural components of the building.

In Kramertown Company, Inc. vs. Commissioner, 488 F.2d 728 (5th Cir. 1974) aff'g, TCM 1972-239 the court held that shopping center roof top heating and air conditioning units were structural components and did not qualify as Section 38 property.

In Circle K Corporation and Consolidated Subsidiaries vs. Commissioner, Docket No. 3542-80, T.C. Memo 1982-298 the court in this case held that the air conditioning units installed on roofs of convenience food stores were structural components of the building and did not qualify as Section 38 property for investment tax credit purposes. Since the taxpayer marketed the food stuffs rather than processed them and since the main reason for installation of the units was to provide for the comfort of the taxpayer's

customers, the air conditioners did not fall within the exceptions contained in Reg. 1.48-1(e)(2).

A.C. Monk & Company, Inc., 686 F.2d 1058, 4th Circuit, (1982), 82-2 USTC 9551 held that the proper approach (for determining whether an electrical system or part thereof is a structural component) is to determine whether the system has more general uses than simply operating specific items of machinery. Thus, if the wiring and other components of the electrical system could be adapted to other operations, they are structural components. An electrical system(s) can feasibly be adapted to uses other than the specific machine it was designed to serve.

Revenue Ruling 81-66, 1981 C.B. 19 states that, activities involving the sale of merchandise, food and other items to the general public for personal or household consumption, and the rendering of services incidental to the sale of goods are considered to be retail activities rather than manufacturing within the commonly accepted meaning of the term.

Discussion

From the aforementioned cases and ruling it can be concluded that taxpayers' central air conditioning and heating systems constitute structural components of a building unless they meet the "sole justification test." Central air conditioning and heating systems which are necessary to provide customer comfort cannot meet the sole justification test merely because the primary consideration in selecting the heating and air conditioning system was the taxpayer's concern for the environmental specifications for its refrigerated display cases. See Circle K Corp. vs. Commissioner, TCM 1982-298.

In the retail food industry, heating and air conditioning systems are installed not only to maintain the proper temperature for open front refrigerated cases which display frozen and refrigerated foodstuffs, they are also installed to provide heat in the winter and storewide air conditioning in the summer. Without heat in the winter, beverages, liquid products and foodstuffs packed in liquid would freeze, and pipes might freeze or burst. Customers would refuse to shop in unheated stores. Additionally, customers would shop elsewhere unless the stores were air conditioned. Air exchanges are required in the National Building Code and the Uniform Building Code in buildings where human activity occurs. Grocery stores are specifically identified in these codes for air exchanges and associated duct work and blowers (ventilating equipment). Grocery stores have heating and air conditioning systems for all the above-mentioned reasons, and the reasons for installing these systems are more dependent on those factors than on the operating requirements of the display cases. Consequently, it cannot be said the "sole justification" for installing these systems is to provide the temperature

necessary for the display cases.

Retail activities such as those carried on by a supermarket are not manufacturing or processing activities (Rev. Rul. 81-66). Therefore, to meet the sole justification test the HVAC system would have to be required exclusively to provide the temperature or humidity requirements of other machinery and provide only incidental comfort to the general store areas.

The supermarket retailer contends that the HVAC system is required to maintain the operational parameters (temperature and humidity) of various refrigerators and freezers located in the grocery store. The parameters of the equipment within the supermarket are included in the considerations of the HVAC design, however there are also a variety of parameters strictly relating to the operation of the building.

In order for the "sole justification" test to be the controlling factor in excluding equipment from the structural component classification, the use of the equipment has to be related only to the equipment it supports. The excluded equipment has to be so closely related to the equipment it supports that is can not be adapted to other uses and will be expected to be retired or abandoned when the equipment it supports is retired or abandoned. See A.C. Monk & Company, Inc., 82-2 USTC 9551. The HVAC systems are not so closely related to the freezer and refrigerator equipment located within the supermarkets that they would be abandoned as the freezers and refrigerators and abandoned or replaced. In fact no one HVAC unit can be singled out as being used to support a particular piece of equipment. The HVAC units all work together to form a totally integrated unit serving the building and the equipment within the building. The HVAC system will remain with the facility even as the business function of the building itself changes throughout the economic life of the building.

In Piggly Wiggly Southern, Inc. vs. Commissioner, 84 TC 739 (1985), aff'd 803 F.2d 1572 (11th dir. 1986) the taxpayer prevailed in claiming investment tax credit on central air conditioning systems installed in its newly constructed and remodeled retail supermarkets. The courts agreed with the taxpayer that the sole justification for the installation of the HVAC system was to permit open front frozen food display cases to operate more efficiently. See Treasury Regulation 1.48-1(e)(2). The Service's position is contrary to that case and holds that HVAC systems are ineligible for investment tax credit because they are structural components of buildings specifically described in Treasury Regulation 1.48-1(e)(2).

It is the position of the Internal Revenue Service that HVAC units located in retail grocery stores or supermarkets which service the building as well as the freezers and refrigerators within the store are structural components of the building since they fail to meet the "sole justification" test specified in the regulations. The HVAC units are not Section 38 property and do not qualify for either the investment tax credit or the ACRS

3 and 5-year recovery categories.